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Review

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The conversion of foreign debt viewed from Latin America

*Eugenio Lahera**

Conversion of foreign debt is an economic policy instrument of both positive and negative potential for the regional economy. The positive potential includes reduction of the cumulative value of the debt and of the interest payments, improvement of the financial situation of enterprises, repatriation of fugitive capital, and direct foreign investment in priority sectors. The negative potential includes a net adverse effect on the balance of payments, increased inflation resulting from increased issue of money, denationalization of the economy using subsidized capital, and crowding out in the use of foreign exchange. The final mix resulting from conversion is determined mainly by the modalities with which this tool is used.

The selection of these modalities ought to be designed to satisfy the national economic priorities, which do not necessarily coincide with those of the groups pushing for the conversion. There is a disjuncture, for example, between the big banks, which are concerned above all to reduce their risks in the region, and the countries, which are seeking to renew the inflow of net external financing. The same situation exists between transnational corporations, which want to make profits from the subsidized purchase of existing assets, and the countries, which want additional investment in sectors producing tradeable goods. Thus, conversion of external debt is a technique requiring, for its correct use, clarity of goals and fine-tuning in implementation.

Conversion has little effect on the position of the regional foreign debt. Perhaps its greatest significance in this respect is the recognition by the banks that the present value of the debt is different from, and lower than, the official value.

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Introduction

The purpose of this article is to analyse and evaluate the modalities of converting Latin America's foreign debt into share equity or financing for other activities in the region. The situation is examined from the standpoint of the Latin American economy. The adoption of this standpoint rules out any in-depth discussion of other assessments, such as those of banks, multi-lateral bodies and governments of the central countries. This method has been chosen in order to keep the article short and achieve a more focussed analysis. In any event, studies made from the other standpoints are legion.

The conversion of foreign debt should be analysed against the background of the crisis which has been affecting the external financial sector of Latin America since 1982. Since that year—and unlike what happened in the 1930 crisis—the continued payment of the interest on the foreign debt became, with a few exceptions, the new consensus of the region's macroeconomic management. This consensus was to some extent involuntary and imposed by external circumstances: between January 1983 and September 1986 a committee of bankers co-ordinated 93% of the commitment of long-term bank loans for Latin America, and these loans were made in the context of debt rescheduling agreements (OECD, 1987, and IMF, 1987). There is a very marked contrast between the 1930s situation, characterized by the wide dispersal of bond holders, and the present control exercised by a handful of banks.

The implementation of severe recessionary adjustments, including the radical reduction of imports which artificially produced a positive trade balance incompatible with full employment, facilitated a continued net transfer abroad, which amounted to US\$130 000 million by the end of 1986 (SELA, 1987). Real wages and employment fell, and inflation rose.

In the more concrete area of the foreign debt, several governments of the region took steps designed to obtain positive results in the decade's main variable: the continued payment of an external debt which was unpayable on its official terms. These measures included exchange rate insurance for borrowers, cancellation in advance, State backing of private foreign

debt, and the conversion of foreign debt, the topic of this study.

The topic of conversion of foreign debt lies at a thematic crossroads, involving mainly direct foreign investment but also monetary policy and the flight of capital. It allows of many modalities, and some of the resulting differences are merely formal or of secondary importance; others, however, modify substantially the effect of conversion on the different macroeconomic variables. It is thus necessary to establish a typology of conversion schemes.

This study consists of four parts. The first describes conversion in general terms, the second analyses each individual country in which it is used. The third part evaluates the impact of conversion on the following aspects of Latin America's economy: balance of payments, direct foreign investment, laundering of capital, local finances and foreign control of the national economy. The fourth and last part draws some conclusions and outlines various possibilities with respect to this topic.

I

Characteristics of conversion

1. *What is conversion?*

Capitalization of a debt is a long-established financial operation which represents the concretization of the risk incurred by the debtor in the event of non-payment of a debt. When a debt obligation is not met it is normal for the collateral to be used as a means of liquidating the financial obligation; this collateral often consists of participation in the equity of some commercial operation of the debtor. These modalities are common in local loans but they have not yet occurred in the case of public loans, where it is simply a question of a State guarantee. Problems can also arise in the private sector when this capitalization implies the transfer of assets to foreign factors. The crisis in Latin America's external financial sector and the subsequent creation of a secondary market for doubtful loan instruments have opened up this possibility.

The market value of a loan contract is the current value of the expectation of payment being made according to the terms of the contract. In the majority of cases the contractual value will be a little higher than the market value in order to cover the risk of non-payment. When the creditor and the debtor have a legal residence in the same country, any conflict that may arise is resolved in the courts by means of bankruptcy proceedings. When this is not the case, the debtor's difficulty in obtaining new financing is due to the fact that the potential creditors will be obliged to share the anticipated loss (the difference between the market value of the obligation

and its contractual value). The attitude of the creditors will be influenced by the market value of the debt as well as by the willingness or ability of the debtor to meet his obligations (Dooley, 1987, p. 7).

The idea of converting debt into equity is also used in the reorganization of bankrupt enterprises: part of the debt is converted into shares in the company, and this reduces the debt and the interest payments. The creditors receive shares and if the company recovers and prospers, they will obtain profits, as happened in the case of Chrysler (Weinart, 1986/1987, p. 89).

There are various types of capitalization. The simplest one is when the debtor and creditor entities form part of one and the same enterprise, as happens in a transnational corporation. The situation is more complicated when the creditor is a different company, a bank for example. Both cases occur in current commercial practice. However, there is a third possibility: the formation of a common debt fund from which an agent can select any instrument for capitalization in assets of his choice in the debtor country. This implies a deliberate policy.

2. *Mechanism of the conversion*

Most of the conversion systems assume the purchase of a foreign obligation by a local or foreign agent—an investor if he subsequently invests—or by a commercial bank. The agent then changes this obligation into local currency with

the central bank—at or a little below its nominal value—or into a debt instrument in local currency which can be traded in the local bond market. The original debt is thus extinguished (Sloakes, 1986, pp. 40 and 41). The proceeds of this transaction can be used to purchase an equity participation in a local enterprise, to increase the plant and equipment expenditure of an existing enterprise, to extinguish pending obligations in the local currency and improve the enterprise's cash flow, or for any other legal purpose.

Conversion of foreign debt therefore implies the purchase—by local residents or foreign investors—of obligations of the debtor country in foreign currency at a given discount rate and their conversion into the local currency at a lower discount rate. In the case of residents, the operation can amount to a repatriation of capital. Agents thus obtain funds in local currency which they can use for authorized purposes. These funds are cheaper than those obtained in the official exchange market and in the parallel market (*World Financial Markets*, September 1986, p. 8).

Table 1 shows the market quotations of the foreign debt notes of several countries and their variation since June 1985. Its complement is the discount rate applicable to these notes. The price is a reference price, since this is a very opaque market which carries out many more operations than are published, and at different prices.

This discount is justified mainly by the doubt as to Latin America's payment of its foreign debt at its nominal value. The doubt is based on the difficulty of continuing both the transfer abroad of part of the region's product and the implementation of recessionary adjustments. The generation of trade surpluses is also encountering growing difficulties. All these factors have joined with the lack of an alternative plan for positive adjustment, which would enable Latin America to restructure its economy and continue to develop, to create a situation of partial non-payment of the debt. Eight countries of the region, including Brazil, have suspended or imposed conditions on their foreign debt payments. Although hardly anyone expects a general moratorium, the North American banks are already envisaging a reduction of payments, and this has been reflected in the selling price of the shares of the biggest banks, which has fallen by

60% in relation to the market price. The market was already applying discounts even before Citicorp increased its reserves (*Fortune*, 30 May 1987).

The conversion operations carried out in the region total US\$4 895 million (table 2).

3. Agents

Many different kinds of banks have been selling discounted debt. In the beginning it was mainly banks with only small amounts invested in doubtful debts which they wanted to reduce or eliminate from their portfolios; others wanted to exchange one type of financial investment for another; and others which had taken precautions against losses and could absorb the discounted sale. They were mainly European and Japanese banks, but among them were a few North American regional banks. The big United States banks continued to count these debts at their parity value, for if they sold debt at a discount they would have to recognize the loss and use it to punish the other loans in the country in question. These banks engaged in a lot of brokerage, but they did not feed the market with the instruments they held.

As capitalization business has increased, these banks have changed their attitude and are participating ever more actively in this market, crowding other intermediaries out of it and in some cases selling their own notes. This has happened in the case of Citibank, Bankers Trust, Libra Bank and the Bank of Montreal (*Fortune*, March 1987). The Industrial Bank of Japan and Sumitomo have been active in Japan.

The situation was given a jolt when in May Citicorp announced that in direct relation to its doubtful loans it was increasing its reserves by US\$3 000 million. This decision unleashed a wave of similar moves by the other main United States banks and it perhaps marked a turning point in Latin America's financial relations with the banks. Citicorp is now in a better negotiating position both with Latin America and with the United States Government. The main consequences with respect to debt conversion is that, at least for Citicorp, lending new money just to ensure continued payment of the interest on the debt has become a thing of the past. Among other things, this produced a large increase in

the supply of foreign debt instruments for conversion. At his press conference on 19 May the President of Citicorp announced that for the next three years it was expected that US\$1 000 million of the expanded reserve would be used to cover losses resulting from the conversion discount. These losses would range between US\$2 000 and US\$3 000 million in those years, depending on the discount. As the President of Citicorp said: "we are not going to get anywhere by giving out new 20-year loans subject to all

kinds of restructuring... Today it is a much better idea to invest in a profitable company in, say, Brazil than to keep lending money to the Central Bank of that country... In the next few years we are going to try to relocate and capitalize a large part of the money we are owed... We will invest in anything that is economically advisable... We are even ready to withdraw our investment if somebody is interested in buying our share ten years from now. This is because we do not want to be long-term capital investors" (Reed, 1987).

Table 1

VALUE OF FOREIGN DEBT NOTES, BY COUNTRY

(100 ~ nominal value)

Country	1985		1986		1987		
	June	January	June	December	February	March	May
Argentina	60-65	62-66	63-67	62-66	62-65	63	58
Bolivia			I ^a			55-10	11-13
Brazil	75-81	75-81	73-76	74-77	73-75	69	62
Costa Rica				40		45	
Colombia	81-83	82-84	80-82	90			
Chile	65-69	65-69	64-67	65-68	68	68	71-72
Ecuador	65-70	68-71	63-66	63-65		62	50
Mexico	80-82	69-73	55-59	54-57	56-58	58	58
Peru	45-50	25-30	17-23	16-19	16-19		14
Uruguay			64 ^b				
Venezuela	81-83	80-82	75-78	72-74	72-74	72	72-75
Philippines				72-76	74	74	70

Source: June 1985 to December 1986: Shearson, Lehman Brothers, Loan transactions group. *The Economist*, London, 21 March 1987; February 1987: *Fortune*, 30 March 1987 and Shearson Lehman Brothers, *op.cit.*; March 1987: *Business latin America*, 20 April 1987.

^aMay 1986, R. Dornbusch, *T¿¿ debt problem and some proposed solutions*, Cambridge, Mass., Massachusetts Institute of Technology, 1986.

Table 2

FOUR LATIN AMERICAN COUNTRIES: AMOUNTS OF FOREIGN DEBT CAPITALIZATION

(Millions of dollars)

	1984	1985	1986	Total	Total foreign debt	1986
Brazil	745	581	600	1 926	108 200	1.8
Costa Rica			60	83	4 240	2.0
Chile		375	812	1 186	22 000	5.4
Mexico			700	700	105 900	1.5
Total	745	956	2 172	4 895	370 000	1.3

Source: Official information for each country.

This event illustrates perfectly the divergence between the interest of the banks which take this attitude and the interest of Latin America. The banks' second-best solution is not what was expected of them as their main activity by the countries of the region. Secretary of State Baker said that a counterpart of the new funds envisaged in the Baker Plan was the creation of a more favourable environment for foreign investment. The banks decided to take a short cut: to acquire the goods without lending the money. Of course, not all the banks will copy the Citicorp strategy; we will have to see what happens.

Other conversion agents are local or foreign financiers who want to invest, finance productive and other operations, repatriate capital or use profitably the foreign exchange that they keep in the country. A small group of big commercial and merchant banks, together with firms of lawyers or intermediaries, are earning fat commissions by matching up the supply and demand for notes. A swarm of intermediaries, advisers, economic and political analysts and public relations men has thus appeared on the scene. Even the *New York Times* (5 May 1987) has mentioned the interest of these banks and firms as one of the driving forces of conversion.

4. *Theoretical advantages of conversion*

From the standpoint of the creditor banks, to sell debt notes at a price lower than their face value ensures the partial payment of a doubtful debt (hence the discount) and enables them to reduce or alter the percentage of investments in a country or region.

The creditor banks which sell the notes improve their portfolios, eliminate their exposed debts and obtain a partial advance payment of a doubtful debt. On the other hand, if they sell the notes to third parties, they accept that the risk for which they had charged a higher interest rate when they made the loan actually occurred. If they carry out the transaction directly, they exchange a financial asset for a real asset; they can thus improve their position, for 100 units of doubtful debt are converted into 95-100 units of the better local assets, which are profitable to boot and can be sold a few years later with a gain. This operation is usually too

complex for the small banks to carry out. By cancelling the original debt, the bank gains a greater degree of freedom with respect to the countries, and this—in the case of Latin America—enables it to get rid of the burden of this chain of debtors.

The agent obtains local financing at a lower cost than in the local market and at less than it would cost him to bring in foreign exchange from abroad and change it in either the official market or the free market. The transactions follow the ups and downs of the relationships between discounts, commissions and the exchange rate differential.

For the local firms which want to reduce their debt in the local currency, this system is a cheap way of improving the flow of funds and increasing the firms' profitability, with a view to financing a future expansion. A country which authorizes the capitalization of its foreign debt obtains the resulting reduction of the volume of this debt and of the annual interest payments, and this is achieved with an actual payment smaller than the face value of the instruments in question.

Not all the legal terminations are directly productive. Furthermore, it is difficult, if not impossible, to avoid running foul of some of the banks—such as the one on recycling of used dollars. The multilateral financial bodies have supported debt capitalization as a partial solution to the problem of a possible moratorium. According to recent statements by David Mulford, United States Under-Secretary of the Treasury, the United States Government openly supports this initiative and it is part of the Baker Plan.

It would thus seem to be a faultless solution which leaves everybody happy. This swapping of a debt for an asset warrants the unanimous approval of foreign creditors, international banks, transnational corporations, central banks and the financial systems of a number of Latin American countries, the International Monetary Fund, the World Bank and the United States Government. Everyone seems to gain from conversion, but to see whether this is really so it will be necessary to examine its real terms and results; this will be done in the following section.

Table 3

EIGHT LATIN AMERICAN COUNTRIES: CHARACTERISTICS OF FOREIGN DEBT CONVERSION PROGRAMMES

	Argentina	Brazil	Costa Rica	Chile	Ecuador	Philippines	Mexico	Venezuela
GENERAL ASPECTS								
Date of programme start-up	May 1987	December 1982 June 1984	August 1986	May 1985	December 1986	August 1986	April 1986	April 1987
Type of convertible debt	Public	Public, private	Public, private	Public, private	Private	Public, private	Public	Public, private
Acceptable uses of local currency binds	Investment, payment of local debt	Investment	Investment	Investment, payment of local debt, others	Investment	Investment	Investment, payment of local debt	Investment, payment of local debt
Authorized operators	Banks, TNCs, firms	Banks, TNCs	Banks, TNCs, firms, individuals	Banks, TNCs, legal and natural persons, nationals under ch. XVIII	Banks, TNCs, firms, individuals	Banks, TNCs, firms, individuals	Banks, TNCs, individuals	Banks, TNCs, firms
Programme ceiling	US\$2 000 million in 5 years	None	None	US\$2 000 million	US\$1 346 million	US\$6 000 million	US\$8 500 million	None
OPERATIONAL ASPECTS								
Time limits	Yes	No	No	Yes	No	No	Yes	No
Exchange rate	Central Bank buyers' closing rate	Official	Official	Dollar Monitored	Official	Official	Official	Bs. 14.5
Central Bank means of payment	Australes	Cruzados	Bonds	Pesos or bonds	Sucres		Pesos	Bolívars or bonds
Exchange price	100%	100%	Up to 70%	100%	100%	100%	70% - 100%	100%
CONDITIONS								
Priority investment sectors	Yes	No	Yes	No	No	Yes	Yes	Yes
Purchase of assets	No	Yes	Yes	Yes	No	Yes	Yes	Yes
Application of foreign investment mics	Yes	Yes		No	Yes		No	Yes
Need to bring in new funds	Yes	No	No	No	No	No	No	No
Special conditions for remittance of profits	Not for 4 years	No limit	No limit	Not for 4 years	Not for 4 years	No limit in priority sectors. Not for 4 years in others	For 5 years must be less than interest	Not more than 10% for 3 years
Conditions for repatriation of capital	Not for 10 years	Period not less than original debt	Period not less than original debt	Not for 10 years	Not for 12 years	Not for 3 years in priority sectors and 5 years in others	Not for 12 years	Not for 5 years. Not more than 12.5% in next 6 years
Operation in stock market	No	No	No	Under study	No		No	

II

The conversion as such

1. Background

The systems of foreign debt conversion have much in common but also large differences (table 3). The debt to be converted is both public and private in most cases, but in Argentina and Mexico it is only public, whereas in Ecuador it is only private. The accepted uses of the local currency funds include exchange for assets in all cases but also payment of local debt in Chile, Mexico and Venezuela. The agents are usually banks and transnational corporations, but local enterprises and individuals may make transactions in several cases. Several countries have not set any limit on the extent of the system, but Argentina, Chile, Ecuador, Philippines and Mexico have done so, for a potential total of US\$20 800 million. Most of the countries have not set any time-limits, except for Argentina, Chile and Mexico. The official exchange rate or some variant of it is usually used. The means of payment is usually the local currency on bonds or both. The swap price is usually the nominal value of the notes, except in Costa Rica where it cannot exceed 70% thereof, and Mexico where it fluctuates between 70 and 100%.

Most of the countries have priority investment sectors, but not Brazil, Chile and Ecuador. In most of the countries it is also possible to buy assets, but not in Argentina and Ecuador. The usual foreign investment rules are generally applicable, but not in Chile and Mexico. With the exception of Argentina, there is no obligation to put in new funds, nor is there any incompatibility with other promotion schemes. Almost all the countries impose some time-limit on remittance of profits and repatriation of capital.

Lastly, no country so far allows debt conversion funds to be used in the stock market.

2. The implementation of the system by countries^a

a) Brazil

Law 4131 on foreign investments authorizes the conversion of loans into equity. During the 1980s in Latin America Brazil pioneered the implementation of a system for swapping debt

for equity; in December 1982 fiscal incentives were introduced to promote conversion, including tax cuts from 5 to 10%. These were revoked in June 1984.

Brazil also has the largest amount of converted debt: US\$1 926 million. Most of this amount is accounted for by transnational corporations which have transformed into share capital their foreign debt with the corporation's subsidiaries, subject to the restrictions contained in the foreign investment regulations. The repatriation of the capital was confined to the terms of the original loan, eight years in most cases (*Business America*, 19 January 1987, p. 3, and IMF, 1987). However, this procedure has also been used by transnational corporations to remit profits (*Business Latin America*, 27 June 1984, p. 204, and *Euromoney*, August 1986, p. 69)-

From June 1984 conversion was confined to the direct equity of the debtor in intra-company loans and international and external loans guaranteed by the parent company. At the beginning of 1985 the tax allowance was likewise restricted.

The programme had a moderate inflationary impact while it lasted, for no steps were taken to neutralize the increase in money in circulation (Marques Moreira, 1986). It was finally discontinued in early 1986, although some transactions are still carried out on the basis of case by case approval (*The Economist*, 7 May 1987).

The Central Bank is at present considering the possibility of re-authorizing capitalization. The new conversion plan is encountering powerful political resistance and its details are still not known. However, there is speculation that the purchase value of the discounted notes will range between 65 and 100% of the nominal value, depending on the investment and the region. It will be possible to use the resulting local currency only for new investments or for capital widening and not as working capital for the payment of local debt.

The programme will include special incentives for firms which carry out swap transactions

^aThe countries are taken in the chronological order in which they began to implement the system.

for exports. Remittance of the profits of these firms will be based on a percentage of the net exports and not of the equity. Investment in shares using conversion funds may also be authorized, as Brazil's stock market is the largest in the debtor countries (*Business Latin America*, 27 April 1987).

b) *Chile*

In May 1985 the Central Bank of Chile established two methods of converting external public debt and private guaranteed debt in different chapters of the Law on International Exchanges: chapter XVIII, covering only local transactions, and chapter XIX which covers overseas ones as well. The Chilean programme has the highest rate of debt conversion in relation to its cumulative value (5%). In both systems foreign debts with terms longer than 365 days can be used for conversion into assets, debt payments in local currency and other activities in Chile.

Except in the case of a bank which uses its assets in Chile for the transaction, the notes are bought at a discount in the secondary international market. Before making the conversion the agent makes an application to the Central Bank for approval in a funds proposal. The conversion is made at the current dollar exchange rate. Once the application has been approved, the note is exchanged for national currency or bonds expressed in national currency at a nominal value. Under chapter XVIII the Central Bank keeps a commission of about 16%, which is not the case under chapter XIX. The foreign debt is thus cancelled. Most of the debt is converted into financial instruments, which are later sold at a discount in the local market to obtain national currency. The current discount is 10 to 15%. According to information from the Economics Ministry, the limit imposed on the programme by the government is between US\$2 000 and US\$4 000 million (*Euromoney*, August 1986). Chapter XVIII authorizes individuals and enterprises to buy with their own foreign exchange foreign debt instruments with terms longer than 365 days. Prior agreement between the purchaser and the debtor is required for the acquisition of instruments, for the obligation will be immediately payable in Chile on delivery of the document. This agreement is not required for notes of the Central Bank, which can be swapped

directly for negotiable instruments expressed in units of investment at a discount of 3% of the original value. The principal of this instrument will have a term of 10 years and the interest will be payable quarterly.

The amount of these transactions may not exceed the principal or the balance of the debt in the original instrument plus the respective interest.

A local agent, through a foreign agent, locates suitable Chilean external debt and buys it at a discount. This purchase is financed with the agent's own dollars or dollars bought in Chile's parallel market or with own dollars from abroad. This third possibility may amount to a repatriation of capital. The person concerned then authorizes a local bank to obtain the agreement of the Chilean debtor for the redenomination of the foreign debt in national currency. This bank submits an offer to the Central Bank for part of the monthly quota to be allocated to the highest bidder, stating how much it will pay for the conversion transaction.

Once the Central Bank has given its approval, the obligation is purchased and it is redenominated in pesos by the local bank, thus creating a new domestic debt instrument. The foreign debt is cancelled and the new (indexed) instrument is delivered to a local agent. The bank's costs in obtaining the quota are passed on to the agent. The new debt is placed in the local market at about 92% of its value. The resulting amount is handed over to the agent.

The advantage of chapter XVIII does not lie solely in the lower cost of local currency funds resulting from the difference between the discounted and the nominal value of the note, less the cost of obtaining the quota and the difference between the parallel market exchange rate and the official rate used for the transaction, but also apart from the profit gained, in the possibility of laundering capital withdrawn from the country or from the public accounts of the enterprises.

Chapter XIX authorizes individuals or legal entities, Chilean or foreign, resident or non-resident, to invest in Chile by purchasing and using foreign debt instruments, with the right to use the foreign exchange market to send capital and profits abroad. This chapter has antecedents in the Decree with the Force of Law No. 600, which regulates direct foreign investment in

Chile and includes among its provisions the possibility of capitalizing duly authorized debts and non-remitted profits. Both types of capitalization constitute an input of capital which carries with it the right of unlimited remittance and of repatriation after three years.

Creditor banks can carry out transactions with their own notes or these notes may be bought at a discount by third parties in the secondary market. The persons concerned must make an application to the Central Bank, identifying the applicant and describing clearly the proposed investment. As in the previous case, an agreement is required stating that the debt will be paid in Chile on the terms indicated. Central Bank instruments do not require this agreement. In no case may the amount of the transactions exceed the value of the original instrument.

Applications may be accepted or rejected by the Central Bank, which may make its approval subject to part of the investment being made with the proceeds of the sale of foreign exchange in the free market, but it has not so far done this. If it approves the application, the Central Bank may authorize remittance and repatriation; the profits may not be remitted during the first four years, and from the fifth year only 25% of the net profits may be remitted. Profits obtained after the fifth year may be remitted without restriction. Capital may only be repatriated in the amount of the proceeds of the alienation of assets or rights corresponding to the original investment. Remittances are made at the bank exchange rate. The note is thus acquired by the agent and then redeemed by the original debtor in pesos at a discount of 10% of the nominal value. The investment is made with the proceeds.

When the debtor is the Central Bank, the debts are converted into national currency notes at their nominal value and at the official exchange rate. Otherwise the terms are agreed in each case. The Central Bank holds the information and controls remittance and repatriation.

The legal guarantee of transactions under chapter XIX is an agreement with the Central Bank, unlike investments under Decree Law No. 600 which are guaranteed by a contract-law with the State. The general taxation schedule is applicable, and the possibility granted under Decree Law No. 600 to other forms of foreign

investment to opt for tax exemption for 10 years is not available. There are no sectoral limitations and established or operating public or private enterprises may be acquired. There is no difference of treatment among sectors and conversion is not an alternative to special development schemes. There are no pre-established quantitative limits, but each transaction must be approved by the Central Bank, and this enables the Bank to control the system (table 4).

In August 1986 the Central Bank established a third method of capitalization, by means of which persons acquiring Chilean foreign debt instruments may apply them to the subscription and payment of shares issued by enterprises which need to increase their capital because of excessive debt. Chileans and foreigners may take advantage of this provision, which makes it different from chapter XVIII. There is no right of remittance or repatriation. These transactions are not subject to Central Bank quotas; therefore, no interest or taxes are payable on the value added. Another method is the recycling of the debt notes of public enterprises contracted with overseas suppliers to enable these enterprises to reduce their obligations. The foreign debt notes issued by enterprises such as Ferrocarriles, Endesa and the Metro which are not included in the renegotiation of the foreign debt can be transferred to the country and handed over to the Treasury, which will accept them at a larger discount than under chapters XVIII and XIX (*El Mercurio*, 15 August 1986).

There are other methods of reducing the debt, such as forgiveness of part of it under a bilateral agreement; however, this does not amount to conversion of foreign debt.

Up to February 1987 transactions under chapter XVIII amounted to US\$594 million and under chapter XIX to US\$441 million, to which could be added the capitalization of debts under DL 600, which are suspended. Transnational corporations have preferred to buy others' debt at lower prices, keeping their own debt in force. Transactions of this kind have been used for the purchase of enterprises and about half of them have been attributable to pension and insurance funds (table 5), with working capital included in the category.

Some financial advisers and foreign banks have indicated the possibility of establishing an

international mutual fund in Chile with a view to attracting resources from insurance companies, pension funds and other institutional investors which want to invest in specialized portfolios (*El Mercurio*, 20 March 1987). At the same time, inputs are envisaged for investing these funds by means of chapter XIX transactions with foreign debt notes (*La Epoca*, 17 June 1987). These bodies may not own more than 5 % of the equity of a single issuer, nor may their investments in an enterprise exceed 10% of the Fund's assets. Remittance of profits will be subject to a single income tax of 10%.

c) *Mexico*

The Mexican capitalization programme started up in April 1986. Foreign investors may buy foreign debt of the public sector at a discount

in the secondary and exchange markets at the official peso exchange rate for use in authorized investments. It may also be swapped for Mexican Treasury notes which are traded in the market to obtain local currency.

The debt is redeemed at 70 to 100% of its nominal value, depending on the purpose for which the pesos obtained in the transaction are to be used. The authorized purposes include the purchase of enterprises which are being privatized; repayment of loans in pesos to Mexico's nationalized banks; prepayment in pesos of Ficorca² obligations; and payments to national suppliers. The highest priority, and therefore the lowest discount, applies to the sale of selected State enterprises and new investments

exchange insurance scheme of the Bank of Mexico.

Table 4
CHILE: FOREIGN DEBT NOTE TRANSACTIONS, BY TRANSACTION TYPE
(Millions of dollars)

	Capitalization 1U600 + others			Ch XVII			Ch. XIX			Portfolio swaps			Debt forgiveness and others			Tot ui		
	May 1981	August 1986	Feb. 1987	May 1986	August 1986	Feb. 1987	May 1986	August 1986	Feb. 1987	May 1986	August 1986	Feb. 1987	May 1986	August 1986	Feb. 1987	May 1986	August 1986	Feb. 1987
A. Public sector (a+b+c+d)		•		84	168	290	87	92	344	13	32	42	-		57	183	292	733
a) Central Bank		-		45	49	56	60	60	232	10	11	12				115	119	300
- New funds			-	41			34						-			75		
• 1983/1984 rescheduling	-		-	4			26						•			30		
- Others										10						10		
b) State Bank				6	18		44				4	4	5		-	9	22	49
- 1983/1984 rescheduling			-	6						-						6		
- Others	-		-							4			•			4		
c) Public enterprises	•	-		8	36	42	27	32	35			2	-		57	35	68	136
d) Private sector with public guarantees				25	65	149			77		17	22				25	82	249
- 1983/1984 rescheduling of private financial sector	-			25									-			25		
B. Private sector (a+b)	149	149	155	155	213	304	42	66	101	37	19	26	155	200	358	538	647	944
a) Private financial sector	63	63	65	147	204	295	42	66	101	34	16	23	14	14	34	200	262	517
- Article 14 loans	63	63		147			42			34			14			300		
b) Private enterprises sector	86	86	90	8	9	9				3	3	3	141	186	324	239	285	426
- Article 14 loans	86	86		8						3			133			231		
- Others													8			8		
Total (A + B)	149	149	155	239	381	594	128	158	445	51	51	68	155	200	414	722	939	1677

Source: Central Bank of Chile

Table 5

CHILE: SECTORAL DISTRIBUTION OF DEBT
CAPITALIZATION TRANSACTIONS UNDER
CHAPTER XIX, MID-1985 TO
OCTOBER 1986

(Millions of dollars and percentages)

Sector"	Amount	Percentage
Pension funds and insurance companies	81.0	43.0
Industry	30.9	16.4
Trade	15.8	8.4
Fisheries	11.0	5.8
Transport and communications	9.3	4.9
Forestry and farming	7.3	3.9
Mining	2.9	1.5
Miscellaneous	30.3	16.1
Total	188.3	100.0

Source: Central Bank of Chile.

"Increases in working capital have been included in the enterprises' sectoral category.

or capital widening which generate exports, reduce imports and create jobs, or are located in special zones (*World Financial Markets*, August 1986, pp. 11 and 12). The funds may not be used for working capital, except in support of an increased capitalization programme (*Business Latin America*, 1 August, pp. 270 and 271).

Although in principle Mexican companies may not use the programme, in two cases already contracts have been signed through subsidiaries of Mexican companies abroad (*Financial Times*, 5 January 1987). It has recently been confirmed that local firms may participate, with priority given first to export companies and then to subcontractors and tourism companies. Transactions in 1987 were below US\$1 200 million (*Business Latin America*, 9 February 1987, and *The Economist*, 1 March 1987).

All the transactions require authorization from the Economics Ministry and the National Foreign Investment Council. Once the conversion has been approved, an additional complication comes into play. The proceeds in local currency are deposited in the Treasury and disbursed directly to suppliers, creditors and contractors on presentation of the corresponding documentation.

The approved investments cannot guarantee profits not related to their income levels and effective profits, and the terms of the conversion of the instrument may not be more favourable than those of the original loan (IMF, 1986). The remittance of profits in the first five years may not exceed the interest on the original debt. Capital may not be repatriated for 12 years (*Business Latin America*, 20 April 1987).

The Mexican programme was suspended in February 1987 owing to lack of progress in the renegotiation of the foreign debt. Half of the 60 banks (mostly in the United States) which had refused to commit new funds in the renegotiation will not be able to participate in the conversion programme (*Business Latin America*, 18 March 1987). Moreover, in order to offset the inflationary impact of the programme, it has been limited to US\$100 million per month (*América Economía*, No. 4, 1987, p. 28).

d) Costa Rica

Costa Rica's capitalization programme began in August 1986; it includes tax exemptions for investment in priority sectors, such as those which generate non-traditional exports, tourism and the new free zones in which assembly work for export is being developed. The first investments were in the banana industry, the financial sector and flower growing (*South*, December 1986). The Central Bank considers applications case by case and pays up to 70% of the nominal value; the bonds which are issued are sold at a discount. There are no restrictions on the immediate remittance of profits. Repatriation of capital may begin only after a period equivalent to the term of the original debt (*Business Latin America*, 20 April 1987). The possibility has been indicated of establishing a plan for buying Costa Rica's foreign debt notes at a discount of 25% (lower than commercial discount) for forest conservation projects (*Umana*, 1987). Up to May 1987 transactions amounting to US\$83 million had been processed, and no new operations are envisaged for the moment.

e) Philippines

Detailed regulations concerning the conversion programme of the Philippines were published in August 1986; the programme is open to

local and foreign investors. Almost all the external public debt and most of the private debt can be traded. The notes are swapped by the Central Bank at the official exchange rate, provided that the proceeds are used for investment in selected economic sectors, each of which has its own priority.

The sectors receiving preferential treatment include industries producing exportable goods, the farm sector, construction and health and education services. In these sectors there are no restrictions on the remittance of profits, and capital can be repatriated in quotas after the first three years. The terms are different in the other sectors of the economy. The Central Bank charges 10% —and not 5%— on the transaction's value; profits may be remitted only after four years and the repatriation of capital may not begin until the sixth year. These investments also require new funds equivalent to 10% of the value of the converted debt.

The Central Bank has received applications amounting to US\$220 million, but up to October 1986 it had approved only 19 transactions amounting to US\$33 million (*Euromoney*, February 1987).

It has also been reported that the capital of the commercial financial system and of the country's 50 biggest companies amounts to around US\$6 000 million or a little less than a quarter of the debt. Conversion could therefore result in a foreign takeover of the economy.

The Philippines has recently proposed another conversion system: Philippine investment notes. Banks are offered the option of converting the above-LIBOR margin of their interest payments into these notes instead of money. These are foreign debt dollar instruments, without interest, maturing in six years (*The Economist*, 14 March 1987).

f) Ecuador

At the beginning of December 1986 the Monetary Board issued resolution 395/86, approving a capitalization system limited to the private foreign debt which was "securitized" in 1986 in a programme which was subsequently incorporated in the consolidation of Ecuador's foreign debt with the banks in August 1986. Its ceiling is US\$1 346 million (*Expreso*, 5 December 1986).

Nationals and foreigners may buy notes, which will be acquired by the Central Bank at their nominal value less a commission. The Central Bank will deliver local currency to the agent making the capital investment, thereby cancelling the private debt. There will be no monetarization in this programme: credits will be exchanged against debt of equivalent value. The Central Bank will be exempt from granting new loans to replace those paid back by means of capitalization (*Análisis Semanal*, 19 December 1986).

Each contract signed will spell out the limits on remittance of profits and repatriation of capital (*Business Latin America*, 5 December 1986). Profits may not be remitted until the fifth year or capital repatriated for 12 years (*Business Latin America*, 20 April 1987). The capital may not be repatriated within a period shorter than the one set out in the amortization schedule in the agreement on consolidation of the foreign debt.

This transaction is singularly attractive for banks and financiers which need to improve their debt ratio. There are no other restrictions except those governing foreign investment. Resolution 395/86 indicates the possibility of establishing priority sectors, but it is not known whether this will be done by general regulation or individual decisions. However, the capitalization agreement contains an intrinsic selectivity criterion. It is not applicable to the formation of new businesses but only to the conversion of debt into equity; if there is no debt, there can be no conversion. The first conversion transaction was completed at the end of March 1987.

g) Venezuela

Debt conversion is governed by Decree 1521 of 1987, but several aspects are left blank, and these will probably be clarified when the Decree is implemented. The conversion may be effected by means of capitalization of foreign loans, conversion of foreign public debt into foreign investment, and conversion of foreign public debt into national investment. This latter method will be supervised by a special commission, for which the Superintendent of Foreign Investments will act as executive secretary. Applicants have to undertake not to remit profits amounting to more than 10% of the capital for three years; capital may not be repatriated

during the first five years, and during the next eight years the maximum repatriation will be 12.5%; there are no restrictions on repatriation after 13 years.

Conversion into foreign investment may be authorized when the investment is intended for imports substitution or exports promotion, or to prevent the collapse of enterprises or when it is for use in the agriculture and agro-industry sectors, road and railway infrastructure works, tourism, construction of social housing, domestic transport, capital goods, chemical and petrochemical products, electronics and informatics, biotechnology, and aluminium and its processing. Other sectors may be approved.

Once the conversion has been authorized, the Central Bank will buy from the investor notes representing foreign public debt and it will supply him with local currency with which to make the authorized investment. Alternatively, the Central Bank will furnish domestic public debt instruments. The purchase or guaranteed value of the notes will be the nominal value, although discounts may be introduced.

For the conversion of foreign public debt into national investment the Central Bank will buy notes from public enterprises and pay them in cash or with bonds at an exchange rate to be established. Lastly, the capitalization of external loans in debtor enterprises will be governed by Decree 1200, which regulates foreign investments in general.

A general condition for the purchase by the Central Bank of foreign public debt notes is that they shall be converted into domestic debt on financial terms equal or better for the debtor.

On the same date the Economics Ministry and the Central Bank issued an exchange rate agreement which set the rate for the three transactions at 14.4925 bolívars to the dollar (*Latin America Weekly Report*, 11 June 1987).

h) *Honduras*

In June 1987 the Government of Honduras approved a foreign debt conversion operation amounting to US\$6 million. The Central Bank swaps the notes into local currency at 100% of their nominal value. The local currency is deposited in national banks and may be used only to finance local investment costs.

Export projects may use the system, in which case the foreign exchange used for remittance of profits must come from the export earnings of the company concerned. Projects of considerable benefit for the country may also use the system, including probably the privatization of certain public enterprises (*Latin America Weekly Report*, 11 June 1987).

i) *Argentina*

In May 1987 Argentina established a public foreign debt conversion programme, the main feature of which is the requirement of investment of new funds, which must be at least equal to 100% of the nominal value of the debt to be converted.

There is the possibility of integrating the dollar by means of a direct investment of the foreign currency, a six-year loan or application of Bonex'87 at 96% of its nominal value. In all cases a dollar is brought in directly from abroad, but there are other less rigid systems for including the additional dollar. Only 50% of the new funds may be integrated through capital deposited in the investment fund or loans obtained from the International Finance Corporation. The system permits the integration of the new funds by means of foreign exchange spent on the import of investment goods and equipment.

Conversion applications will be valued and selected by public bidding, and the preference given to projects will depend on the ratio of the new funds required to the debt to be converted. Priority will be given to proposals offering a larger input of dollars.

The agent will have to undertake to use the local currency to buy equipment or construct factories or other work which increase the productive capacity and the net supply of goods. Consideration will also be given to investment proposals designed to enhance the efficiency and productivity and increase the supply of services, especially those which strengthen the balance of payments. Permission will not be given for stock market investments financed by the conversion or for funding privatization or investment under the Houston Plan (petroleum).

The conversion operates only with foreign currency already processed through other mechanisms and this currency may not be used for the transfer of existing assets. Consideration is still

being given to the possibility of using conversion to cancel loans obtained through rediscount by the Central Bank (*El Clarín, ed. int.*, 1-7 June 1987).

Investments by foreigners will be subject to prior approval of the investment under the 1980 law on foreign investments. Proposals will not be accepted if they involve the transfer of blocks of stock which affect domestic security or are designed to increase the supply in economic sectors which require rationalization.

The administrative period for approval of the projects before the bidding is 45 days.

The additional funds will have to be brought in before or at the same time as the conversion for projects of up to one million dollars, and in other cases the transaction will be made in accordance with the approved time-table. The investor must deposit a guarantee with the local acting bank or put up a bank guarantee; the same bank will be responsible for acting at all stages of the bidding and of the programme in general.

Once the deposit has been produced —equal to 3% a year on the outstanding balance of additional funds— the Central Bank will convert the obligations into local currency at the agreed prices. The exchange rate used will be the closing buyer's rate of the Banco de la Nación Argentina on the day. The resulting amount will be deposited in the local acting bank and the converted obligation will be extinguished.

The bank will release the deposits in accordance with the agreed schedule and the guarantees will be released in amounts equal to the converted percentage of the total transaction. The same bank will notify the Central Bank of the completion of the transaction.

In the event of non-completion within 60 days the investor will lose the guarantee. If the non-completion is partial, the loss will be so as well. If the additional funds are not brought in, the total guarantee is lost, as is the right to effect the remainder of the agreed conversion. Sanctions will also be imposed.

The acting bank will also monitor the use of the deposit for the project. The additional funds will have to be furnished in accordance with a time-table proposed by the investor and used in the project in the proportion which served as the basis for the approval. The bank will also issue the necessary certificates, approvals and verifica-

tions to ensure the correct and timely use of the funds in the approved investment project.

The programme envisages investments of around US\$4 000 million over five years, of which half will be financed by conversion and half by the entry of additional funds from abroad, either as investment of capital or as medium- and long-term loans.

j) *Other countries*

A special case of swapping has been established by Peru, which has begun negotiations for the exchange of foreign debt notes for goods. Two-thirds of non-traditional exports may be paid for in foreign exchange and the remaining third in Peruvian foreign debt notes. A transaction totalling US\$20 million was carried out in December 1986, when a United States bank accepted asparagus and minerals instead of foreign currency (*Latin America Weekly Report*, 9 April 1987).

The Government of Bolivia made an official offer to the bank which heads the committee for that country to buy at a discount of 90% the US\$671 million owed to 128 commercial banks (*Latin America Weekly Report*, 9 April 1987, and *Business Latin America*, 25 May 1987). It has recently been reported that transactions were being performed for repurchase of public debt at a discount of 75% (*América Economía*, No. 4, 1987).

Jamaica has announced its intention to establish a programme for converting into equity up to US\$100 million of foreign debt with commercial banks. These transactions may be used for new investments in factories and hotels (*The Journal of Commerce*, 25 May 1987).

In Colombia there have been hints of the possibility of initiating a capitalization programme using bank debt, for the discount on the rest of this country's debt would not be sufficient to get such a programme off the ground (*Business Latin America*, 22 September 1986).

The Dominican Republic is exploring the possibility of permitting the conversion of debt into equity. Guatemala is expected to announce shortly a debt-to-equity conversion plan, especially with respect to the stabilization bonds callable in 1988 and 1989.

In Nigeria notes for non-secured unpaid obligations may be redeemed in local currency on

terms agreed between the holders and the Central Bank. If the approved long-term investment is actually made with the proceeds of this transaction, it will be treated as if it has been made in foreign currency with respect to taxation of remittance of profits and repatriation of capital (*International Capital Markets*, December 1986).

3. Other developments

a) *The Japanese corporation in the Cayman Islands*

The 28 main Japanese banks which have lent to Latin America have established a company—JBA Investment Inc.—in the tax haven of the Cayman Islands to buy their own debt notes at a discount. The discount is established by the Japanese Centre for International Finance, a semi-State body set up to examine the situation of the holder countries.

The banks can offset the resulting capital losses against their taxes. The new body receives payments of capital and interest on the original terms; the amounts received are distributed to the banks as profits (*Euromoney*, April 1987).

JBA Investment will begin operations by buying Mexican notes representing US\$13 000 million of the total of US\$36 000 million owed by the region to Japanese banks.⁶ The new company's first goal will be to sell the loans totalling US\$830 million made to Mexico in 1983. Operations will then continue with other public debt of Mexico or other countries.

Some of the possible consequences of this initiative are as follows:

— Increased pressure for the creation of a multilateral system of the same kind by means, for example, of the establishment of a subsidiary of the World Bank specializing in the purchase of third-world debt at a discount (*Business Latin America*, 25 May 1987).

— The Japanese Banks are very large creditors to the region and a large-scale operation in this market will affect the unity of the creditors, which has so often been contrasted with the disunity of the debtors.

⁶The debt of other countries with Japanese banks is as follows, in descending order: Brazil US\$11 000 million; Argentina US\$5 500 million; Venezuela US\$4 300 million; Chile US\$1 800 million.

— The discount rate applied by this body to the sale of the debt will either be limited to the secondary market rates or, what is more likely, it will be a different rate, in which case the existing market will be seriously affected.

— In the medium term the Japanese body will be able to begin other activities, such as debt swap transactions, and even play an active role in debt renegotiation.

— The competitive capacity of the Japanese banks will be improved in the opposite direction to the one envisaged in the Baker Plan, for it will be easier for these banks to de-link themselves from Latin America.

— There may possibly be an increase in direct investment by Japan in Latin America.

b) *Mutual Funds*

The International Finance Corporation (a subsidiary of the World Bank) is urging the debtor countries to form a stock market for foreign investment and establish national mutual funds in which foreign investments can be made. Doubts persist as to who should manage the funds, the taxes to be levied and the type of shares which might be bought by such funds (*The Economist*, 1 March 1987).

As stated earlier, Brazil and Chile are examining the possibility of permitting the conversion of debt into special mutual funds for stock market investment.

c) *Conversion transactions outside the official programme*

Lastly, it must be pointed out that, in addition to the programmes of agreements initiated and approved by the economic authorities of the debtor countries, some creditor banks have swapped notes for capital in private transactions (IMF, 1986). So far most of these transactions have concerned Mexico.

At the end of April authorization was expected for a debt-equity swap between the Grupo Industrial Alfa—the country's main private corporation—and the creditor banks, which was granted in December 1986. The transaction will cover a foreign debt of US\$920 million to be exchanged for 45% of the group's shares, plus US\$25 million in cash and the purchase of US\$200 million of public debt (Council of the Americas, 1987, and *Financial Times*, 10 April 1987).

III

A provisional assessment

1. *The balance of payments*

The question as to whether a conversion system helps the balance of payments can be examined from several perspectives. The first question ought to be about the advantage of repaying ahead of time debt for which normal servicing has been suspended or restricted by several countries and which represents a large proportion of the total debt. The banks have been gradually accepting the possibility of relatively large pardons. Debt extinguished by conversion could not take advantage of any changes in the renegotiated terms.

Conversion reduces the amount of the debt and improves slightly the country's negotiating position with its creditors, but there should be no illusions about the early restoration of the flow of capital to Latin America. The reduction of the debt will not create a new supply of credit and in this sense it will not be beneficial.

From another perspective, the operation does not offer a global solution to the debt problem, nor has anyone suggested that it does. It is sufficient to compare the volume of cumulative direct foreign investment in the region—US\$60 000 million at the end of 1985—with that year's debt, which amounted to US\$368 000 million. It would be necessary to increase six-fold the present volume of foreign investment to bring it up to the level of the debt, even though the ratio would clearly be smaller if discounts are applied to the debt.

Conversion of the debt reduces the amount of annual interest, and this helps the national balance of payments. However, there are two opposite effects which can impair—or even reverse—this result. The reduction in the debt through conversion is offset by the decline in real foreign investment caused by this fictitious investment; it must be remembered that there is no inflow of foreign exchange.

Furthermore, the investment generates future obligations, including remittance and repatriation, which might be greater than the original payment of debt even though occurring

at a later stage. Since the purchase prices of the assets are established in a period of recession—in which they are the prices which offer the best possibility of investment—it is very possible that the converted capital may prove more profitable than the medium-term interest rate. In fact, the net effect of conversion on the country's balance of payments is neither simple nor positive. In the long term, the control exercised by the banks over real assets will probably mean repatriation of capital, for the banks will not wish to retain these assets indefinitely.

Lastly, the fact that the notes are paid at a discount involves a paradox: the conversion checks the rise in the discount rate for the notes and in some cases it would seem to have reversed this upward trend; the discount rate does not rise any further—or even falls—by virtue of the willingness of the countries to pay the debt at this level.

2. *Direct foreign investment*

Given the decline in direct foreign investment in the region and the associated gloomy outlook, it would be useful to have an effective incentive for attracting such investment.

A careful judgement must be made as to whether it is worth losing the positive effect of direct foreign investment on the region's economy in exchange for an insignificant improvement in the foreign debt situation. The conversion system must be evaluated in the context of a national policy for foreign investment, for otherwise it will merely be a question of liberalization and reduction of this investment under another heading; the widespread use of the capitalization system would be one more factor in the reduction of restrictions on foreign investment which is taking place in Latin America, a process which certainly ceased long ago to have much incentive effect.

If optimum investment results are not expected from the conversion scheme, it can be used for many different purposes, including the acquisition of working capital or replacement of

Table 6
ESTIMADES DEBT OF SUBSIDIARIES OF
UNITED STATES TRANSNATIONAL
CORPORATIONS, 1977 AND 1982

(Thousands of millions of dollars)

	Value	
	1977	1982
I. Foreign debt	21.8	38.1
a) Long-term	7.3	16.9
With parent companies	1.5	5.3
With other foreigners	5.8	11.5
b) Short-term	14.5	21.3
With parent companies	5.3	11.0
With other foreigners	9.2	10.3
II. Debt with bodies in		
the recipient country	30.9	47.8
a) Long-term	1.9	4.3
b) Short-term	29.0	43.5
Total debt I + II	52.7	86.0

Source: Estimates of the United Nations Centre on Transnational Corporations in "Foreign direct investment in Latin America: recent trends, prospects, and issues", *UNCTC Current Studies*, Series A, No. 3, New York. United Nations publication, Sales No.: 86.II.A.14, 1986.

local loans. Not all transfers of assets result in greater productive capacity in the national economy, nor is foreign investment equally advantageous in all economic sectors. It might even stimulate unnecessary operations which do not increase national investment, such as the purchase of assets for subsequent resale, all on less explicit terms than before. The quantitative effect of diverting the investment might have unfavourable qualitative implications.

If the flows resulting from conversion are considered to have the benefits of direct foreign investment, a paradoxical situation is created. A foreign currency transaction carried out abroad, as a result of which local assets are bought with cheap local money and at a discount, provides rights equivalent to those resulting from a transaction using risk capital in foreign currency effectively brought into the country which in the short terms increases the country's productive capacity.

Conversion can become a subsidy for shifted investment, which would have taken place in any case without the conversion (IMF, 1986). There is an implicit subsidy when a transnational cor-

poration with x million dollars buys x3 million in pesos to invest today and remit tomorrow from the region.

From another standpoint, this situation concentrates on one factor of direct foreign investment —the capital— but it disregards others, such as technology and exporting capacity.

The foreign debt of the transnational corporations in the region amounted to US\$38 100 million, of which US\$17 000 million was long-term and US\$5 300 million obligations to parent companies (table 6). However, it is interesting to note that, to judge by the available information, the transnational corporations prefer to pay off their debts in full and purchase other cheap debt.

Apart from special cases —such as the imminent bankruptcy of viable enterprises— the purchase of existing assets by transnational corporations brings no great benefit. Moreover, it can encourage speculation in the prices of the assets.

3. *Repatriation and laundering of capital*

In the case of the return of fugitive capital or the laundering of capital, there is a positive saving on the payment of interest without the disadvantage of loss of foreign exchange through debt payments or subsequent remittance. Furthermore, the central bank can reserve to itself part of the discount when such a policy is in force. The repatriation of capital is a clear positive element.

However, as far as can be determined from the available data and although we must await the relevant information before forming a final opinion, conversion is not producing a massive repatriation of capital. Indeed, the success of the system can lead to new flights of capital or revolving movements of capital, i.e., the removal of capital from the country for subsequent re-use in the country, followed by removal once again.

The system implies using the repatriation of capital to pay in advance the foreign debt which otherwise might perhaps have been rescheduled over a longer term. There are other uses for this capital of greater priority for national development (Arellano and Ramos, 1986).

From another standpoint, conversion offers a new profitable opportunity to enterprises

which commit an illegal act in some cases or an act harmful to the country's development in others. It has been said, perhaps with irony, that one of the advantages of converting the debt into foreign investment would be that when foreigners buy local businesses, national financiers might become convinced that it was a good thing to invest in the country itself instead of remitting their funds abroad (*Fortune*, 18 August 1986), and this might halt the flight of capital.

From a perhaps extra-economic perspective, it may be wondered why the owners of assets abroad should be rewarded with capital gains, when for the same objective—the payment of the foreign debt as the main variable of economic policy—real wages and public expenditure fall, with harmful effects on the well-being of most of the population.

4. *Local finances*

One advantage of capitalization is that the debt is paid in local currency and not in foreign exchange. However, it is advanced payment of the debt and it is questionable whether this is justified in the present circumstances of most of the Latin American economies; the payment is financed from national savings or capital, which are diverted from other possible uses. This can lead to speculation or a merely transient improvement with respect to the assets and to juggling of capital gains among economic agents (Dornbusch, 1986a).

From another perspective, if conversion results in an increased money supply, inflation may be stimulated. "When a foreign creditor exchanges its claim on an entity in a debtor country for equity in the same entity, no flows of funds are involved. Domestic monetary conditions are unaffected... When local-currency funds are paid out in exchange for the foreign-currency debt being swapped, domestic liquidity will increase...", although the monetary expansion may be limited in various ways, one of them being the application of periodic installments or quotas (*World Financial Markets*, September 1986).

If the notes are exchanged for bonds which are converted into local currency in the secondary market, the scheme will not have the same inflationary effect, always provided that the volume of transactions is relatively small in rela-

tion to the national money base. However, the programme can have an inflationary effect if the economic authorities do not try or are unable to neutralize the monetary impact of conversion. If the notes are exchanged directly for local currency in the central bank, the monetary authorities should reduce the money supply by an equivalent amount to prevent an expansion of the money base.

In the absence of clear incentives to direct the process towards investment, its main effect may be the allocation of budgetary resources to the financial system which is carrying out these transactions, which ultimately will become simply a form of financing and not a stimulus to genuine investment, which can be promoted with much better means applied more accurately (Dornbusch, 1986b).

From the fiscal standpoint, it is possible that the domestic debt incurred by the redemption of the notes may bear more interest than the original foreign debt. Furthermore, an effect of expulsion from the local financial market may occur.

Lastly, one consideration of interest is the effect of conversion transactions on the exchange rate, especially with respect to the margin between the official and parallel rates. This will depend on the demand created by the conversion transactions and the supply of foreign exchange in the black market, funds which have not left the country but are not official either.

5. *Foreign control of the national economy*

If foreign direct investment is thought desirable, there will inevitably be a relative loss in economic independence, which in an optimum situation will be offset by other advantages. The growth in direct foreign investment as a result of conversion may be viewed through the prism of cumulative investment of this kind throughout Latin America's history, which amounts to US\$60 000 million. Potential conversion transactions might total US\$20 000 million over a few years, which gives an idea of the magnitude of the possible transfers of assets if there are no restrictions.

However, this is not just a problem of quantity but also of quality. Today the supply of assets

is more indiscriminate —as a result of policy liberalization— and the costs are lower owing to the recession. However, the demand is controlled partly by transnational corporations but

also by transnational banks in which the handling of assets is by definition transitory. Is it the best situation when the biggest banks manage on a transitory basis some of the best local assets?

IV

Conclusions and future possibilities

With conversion there may have been discovered a way of increasing national investment while reducing the country's foreign debt, with benefits for all the sectors involved. However, some modalities do give rise to problems in the way in which they are applied at present.

The creditor banks gain from this operation, for they liquidate some risky debts —they would not otherwise sell their instruments at a discount— or exchange their financial assets directly for real assets. At the same time they continue to insist on the total repayment of the rest of the debt. Local residents who launder capital also benefit because they obtain for their dollars a higher local currency rate than in the parallel market. Foreign investors profit because they finance with cheap pesos —the difference between the face value and the value paid— the purchase of real assets at recession prices and their transactions enjoy some of the guarantees offered to foreign investment. Multilateral lending bodies approve because the debtor country thus gives priority to the main variable of real importance to them, namely the payment of the foreign debt. The country exchanges a debt of doubtful origin and problematical recoverability for a certain debt, which is paid by diverting funds which might be used for other purposes, by transferring real assets to new owners or by reducing its working capital.

From another standpoint, conversion makes it impossible to monitor or audit the part of the foreign debt which is capitalized, owing to the superimposition of a commercial transaction involving third parties. This is important in those countries in which there has been criticism of the legitimacy of the debt as well as of the efficiency of its use.

In some cases this amounts to a burdensome method of reducing the foreign debt which can

have major collateral effects. In order to attain the country's objectives —re-entry of capital and increased productive foreign investment— special policies, of benefit both to the countries and to their creditors, should be put into effect in order to increase foreign investment in specific sectors and not merely to reduce the debt.

It is also clear that the various conversion schemes are very different in nature. It makes no difference whether the proceeds of the conversion are used for directly productive purposes, involve new capital, increase the production capacity and are directed toward sectors which generate exports, or whether, on the contrary, these proceeds are freely available —including for speculative purposes—, do not involve new funds and are used mostly for the purchase of existing assets.

It is beneficial to swap unproductive obligations for investment opportunities, especially when the future of foreign investment is uncertain (Weinert, 1986/1987) but the proof of the benefit to the nation is not the dynamism of the process, if the initial conditions are unsuitable.

The main United States banks have recognized that risky investments in the third world have lost their parity value. It might therefore be necessary to recognize the value of the debt market. The reduced face value of the debt represents the market value of the regional foreign debt, but this is a market with peculiar features. Why pay more than the real price of the debt? According to the secondary market in promissory notes, the real value of the notes is at least a third below their face value.

From another perspective, it is difficult to understand how Latin America's creditor banks earn money by dealing in notes at one price while at the same time requiring the payment of other notes at higher prices. The creditor banks

cannot continue negotiating the total payment of the interest owed and carrying out multilateral rescheduling with governments while they are actively participating in the secondary market in discounted notes. The multilateral bodies and the governments of the central countries cannot continue to insist on payment of the nominal value of the debt while at the same time commending the conversion mechanism.

Moreover, it is important to note the terms on which conversion is acceptable. In the case of conversion into foreign investment it is important to determine what foreign investment is needed. If the conversion is to work properly, it must be governed by a selective and efficient policy and not based on differential terms which produce unreal solutions. It might be possible to require an infusion of new capital proportional to the capital of the conversion and to encourage investment in the production of tradeable goods, restricting investment in financial intermediation.

Conversion operations might be made the responsibility of a Latin American fund which

would allocate the proceeds of these transactions to investment.

With regard to the capital which is to be repatriated or laundered, French-Davis (1987) has pointed out that a similar amount might perhaps be obtained by applying a preferential rate, in conjunction with directly accepted laundering of capital. In this way the capital might be put to other uses of greater priority for national development.

It might perhaps be necessary to negotiate with the countries in which external deposits have been placed to persuade them to change the tax regulations with regard to deposits by foreigners. As Dornbusch (1986b) says about United States policy in this respect: "It is also worth recognizing that the capital flight problem is to a large extent of our own doing. The Administration in an effort to fund our own deficits at low cost has promoted international tax fraud on an unprecedented scale. The only purpose one can imagine for the elimination of the withholding tax on nonresident asset holdings in the United States is to make it possible for foreigners to use the United States financial system as a tax haven."

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